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MORTGAGE CREDIT ENHANCEMENTS

Options for FHA in Meeting the Need for Affordable Multifamily Housing

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Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to participate in the Subcommittee's hearing this morning on the Federal Housing Administration (FHA). My testimony today is based on a study that we are currently conducting in response to a mandate contained in the National Affordable Housing Act of 1990. This mandate directed GAO to, among other things, identify legislative or administrative actions that could improve the availability of mortgage financing for affordable multifamily housing through credit enhancements. Credit enhancements are additional collateral, reserves, or third party guarantees to insure the payment of debt obligations.

As you are aware, Mr. Chairman, there are various subsidies that the federal government can use to assist lower-income families so they can afford rental housing. Among the primary ones are Section 8 vouchers and certificates, public housing, low-income housing tax credits, and credit enhancements. As requested, today I will discuss several credit enhancement options which focus primarily on modifications to FHA's insurance programs. The results I am reporting today are preliminary and thus subject to revision as we complete our work. We anticipate issuing our final report on this subject later this year.

To develop these options, we drew upon the expertise of a wide range of senior and midlevel officials representing private financial institutions, including commercial bankers, mortgage bankers, and savings and loan officials; bond insurers; credit rating agencies; government-sponsored mortgage finance corporations; for-profit and nonprofit housing developers; government regulatory organizations; state and local housing finance agencies (HFAs); and community development organizations. We also interviewed selected representatives of academia. We reviewed financial and housing literature, congressional testimonies, and studies pertinent to the subject of mortgage finance.

In summary, there is a broad consensus among those we interviewed that a need exists to improve the availability of long-term fixed-rate financing for affordable housing. The options I discuss this morning are geared toward this objective. These options are (1) delegated processing, (2) delegated underwriting, (3) primary bond insurance, and (4) bond reinsurance. The first two options are intended to improve the availability of government insurance on individual loans, while the last two options would be primarily for groups or pools of loans. Appendix I provides a detailed discussion of each option.

The options, while they would modify FHA's current practice in providing credit enhancements, could be focused initially on HFAs, that have demonstrated their capacity and commitment to affordable multifamily housing. If implemented, this approach would provide

the federal government with the opportunity to evaluate the benefits and risks of these options before expanding their use to other qualified market participants (specifically, the Federal National Mortgage Association, or Fannie Mae; the Federal Home Loan Mortgage Corporation, or Freddie Mac; and additional HFAs).

It is important to note that while these options could increase the financing available for providing affordable housing, additional credit enhancements will expose the federal government to possible costs. This exposure could be lessened by having a comprehensive data base on affordable multifamily loan performance from which reliable underwriting criteria and premium structures could be developed. Such a data base currently does not exist.

Before discussing in more detail the options for providing credit enhancements it is important to provide some context for our work. To do this, I will highlight (1) the need for affordable rental housing and factors having a negative impact on its financing and (2) the benefits of an expanded secondary market for affordable multifamily mortgages.

NEED FOR AFFORDABLE HOUSING AND FACTORS IMPEDING PERMANENT FINANCING

A recent study by the Department of Housing and Urban Development shows that millions of lower-income families pay too much for housing and that too much of the housing they occupy is substandard. This study, along with other studies[1] has also shown that the number of families with these housing problems has been growing and that federal housing subsidies that make housing more affordable only reach about one-third of the affected population.

The basic explanation for this situation is that there is a gap between what it costs to build and operate affordable housing and the rents that lower-income households can afford to pay. For example, a family with a $10,000 annual income can afford to pay about $250 per month according to government guidelines (30 percent of income). However, this amount typically is not sufficient to

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[1]Center on Budget and Policy Priorities and the Low Income Housing Information Service, A Place to Call Home--The Low Income Housing Crisis Continues, (Washington, D.C., Dec. 1991); Cushing N. Dolbeare, Out of Reach: Why Everyday People Can't Find Affordable Housing (Low Income Housing Information Service, Washington, D.C., 1991); Department of Housing and Urban Development, Priority Housing Problems and "Worst Case" Needs in 1989, A Report to the Congress (June 1991); Joint Center for Housing Studies, The State of the Nation's Housing, 1991 (Harvard University, Cambridge, Mass., 1991); Margery Austin Turner and John G. Turner, "Dynamics of the Low-Cost Rental Stock," The Urban Institute, 1991.

allow an owner to make mortgage payments, pay operating expenses, set aside reserves for major repairs or rehabilitation, and earn a profit.

Aside from the income limitations of tenants, financing for affordable multifamily housing has undergone major transformations during the 1980s caused by policy, legal, regulatory, and social changes. These changes, while having positive implications, including curtailing overbuilding in some areas and promoting safety and soundness within depository institutions, have nevertheless generally worked to discourage investment in affordable multifamily housing. For example:

-- Changes contained in the Tax Reform Act of 1986 (lowering the marginal tax rate, lengthening depreciation times, and changing rules concerning passive losses[2]) decreased the profitability of owning affordable multifamily properties, which in turn increased the difficulty of obtaining permanent financing.

-- The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 required that depository institutions maintain twice the capital reserves on multifamily housing loans than on single-family housing loans. There is general consensus among those we interviewed that this has had a negative impact on the willingness of these institutions to finance affordable multifamily housing.

-- The shift from project-based subsidies to tenant-based subsidies has also increased the difficulty of obtaining permanent financing because of the lack of assured rental income.

-- The change to nonstandard state and local housing subsidies from standard federal housing subsidies (i.e., Section 8 subsidies) has added to the difficulty of obtaining permanent financing because of the wide diversity in the subsidies' terms and conditions.

The primary financial markets have reacted to these changes by decreasing the availability of permanent financing for affordable multifamily housing. Expanding the secondary market would help to overcome the impact of these changes by providing liquidity to the primary originators of loans and furnishing a source of permanent financing. As I will explain, credit enhancements offer one set of options for expanding the secondary market for affordable multifamily housing mortgages. However, many affordable housing

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[2]Losses on rental property resulting from depreciation or cash contributions to cover operating deficits.

projects would require additional subsidies to make them financially viable.

NEED FOR AN EXPANDED SECONDARY MARKET

There is a general consensus among those we interviewed that significant barriers exist in accessing capital markets for rental housing targeted to low- and very low-income households. The absence of a high-volume secondary market creates several problems for financing affordable multifamily housing. Most notably, lenders are generally only willing to make short-term adjustable rate loans because holding long-term fixed-rate loans in their portfolio would subject them to losses should interest rates rise. The resulting exposure of projects to the risk of rising interest rates and the uncertainty of refinancing means that fewer affordable housing projects are developed, and more are apt to run into problems than would likely be the case if lenders could extend fixed-rate loans. As I mentioned earlier, the additional capital requirements imposed on depository institutions create a disincentive for these institutions to make multifamily housing loans unless these loans can be sold and the credit and interest rate risk transferred in whole or in part to investors. Finally, from the perspective of the borrower, interest rates for affordable housing are likely to be higher because of the absence of a fully functioning secondary market that would provide lenders with easy access to the capital markets.

A substantial secondary market has not evolved to serve affordable multifamily housing for several reasons. Three of the more important are the risks associated with affordable housing projects, the absence of a reliable data base on borrowers' performance in repaying loans for affordable multifamily housing, and a reluctance on the part of the primary capital market institutions (FHA, Freddie Mac, Fannie Mae, and HFAs) to expand their activity in the affordable multifamily housing market.

Overview of Risk

Targeted to low-income families, affordable multifamily housing tends to be more sensitive to increases in operating costs and interest rates, is more vulnerable to changes in government assistance, and may require more maintenance and management oversight. In addition, the tax changes discussed earlier, coupled with extensions in low-income use requirements contained in the 1987 and 1990 Housing Acts, reduce the long-term value of affordable multifamily properties to owners and therefore their incentive to maintain properties in sound condition over the long term. Therefore, lenders are reluctant to extend long-term mortgages. Finally, there continues to be a lack of credit quality standards for affordable multifamily housing, which are critical in

pricing both mortgage loans and credit enhancements. The lack of standards restricts the expansion of a secondary market.

Data Problems

For a robust secondary market to develop, financial institutions need access to information that will enable them to quickly and cheaply evaluate, price, and manage risk. Currently, there is little information available on loans for multifamily housing in general, or affordable multifamily housing in particular. Without such data, financial institutions are handicapped in evaluating and pricing risks associated with lending for affordable multifamily housing.

Limited Activity by Primary Capital Market Institutions

FHA has historically been the federal government's principal provider of credit enhancements. However, its insuring of mortgages has declined sharply in recent years, from a high of 35 percent of mortgages in 1982 to about 6 percent in 1990.

Freddie Mac had been a major source of permanent financing for multifamily housing during the 1980s. However, in September 1990, Freddie Mac suspended most of its financing for this housing because of large losses caused primarily by inappropriate underwriting. Absent Freddie Mac, Fannie Mae is the primary entity currently active in the secondary market for affordable multifamily mortgages. However, Fannie Mae's underwriting criteria limits their participation in affordable multifamily mortgages.

Finally, state and local HFAs are institutions established to respond to the housing needs of low-income households. With the change in the 1986 tax act, HFAs ability to use tax-exempt financing for affordable multifamily housing has been greatly diminished. Therefore, HFAs with active financing programs for multifamily housing advised us that they have had to issue taxable bonds. According to HFAs, the volume of these bonds, however, has been limited because of the absence of available and affordable credit enhancements needed to attract large institutional investors such as state pension funds.

OPTIONS FOR INCREASING MORTGAGE CREDIT FOR AFFORDABLE MULTIFAMILY HOUSING

Mr. Chairman, I would now like to discuss four credit enhancement options that were developed after consulting a wide range of experts in the housing and finance fields. The first two options provide insurance on individual loans while the last two provide insurance on pools of loans. These options provide a starting point for discussion if an expanded secondary market for loans for affordable multifamily housing is desired. As a first

step, we would suggest limiting the availability of these options to HFAs with demonstrated successful programs for financing affordable multifamily housing. These HFAs are organizations of state government, known entities in the financial marketplace, and publicly accountable to their legislatures. A demonstration with these HFAs can be viewed as an initial first step, which, if successful, may be modified to better assist private financial lending institutions. Our discussions with several state HFAs found them willing to initiate a forward commitment program with local lending institutions within their state.

Under each of the four options, HFAs would agree to assume the expected losses on loans they originate based on their historic loan performance. This is not to imply that the federal government is not exposed to risk under these options. Rather, the federal government's insurance would cover losses beyond those expected and not covered by the HFAs. There is a tradeoff between the risk to the federal government and the impact on the supply of affordable housing. More risk sharing with the HFAs reduces the federal government's risk but it also reduces the amount of the subsidy for affordable housing.

Finally, it should be noted that HFAs may be able to utilize more than one option at a time depending on the HFAs experience and performance record. Moreover, we believe, that each option should include a requirement that projects include a certain percentage of affordable housing units. The minimum percentage should be comparable to, or higher than, the percentage required for obtaining low-income housing tax credits. Also, to the extent these options are implemented, consideration should be given to requiring that projects receiving credit enhancements be consistent with the local comprehensive housing assistance strategy which identifies the specific housing needs of local residents.

<u>Option 1: Delegated Processing</u>

Under this option, FHA would allow selected HFAs to originate/process <u>individual</u> loans and submit loan packages directly to FHA for final approval for full mortgage insurance. FHA would be required to either approve or deny the loan insurance within a specified period of time (e.g. 30 days). This requirement should encourage HFAs to participate in the program while also encouraging FHA to expeditiously act on the loan packages.

<u>Option 2: Delegated Underwriting</u>

This option would delegate underwriting to a selected group of the most experienced HFAs, allowing them to commit FHA to full mortgage insurance on <u>individual</u> loans without requiring final approval by FHA. This authority would only be granted for loans up to a specific amount and for specific types of loans. FHA would conduct post-originating audits on selected loans to ensure that

HFAs are using sound underwriting criteria. This option would allow each HFA the flexibility of applying its own underwriting criteria to meet the needs of its local communities.

Option 3: Primary Bond Insurance

Under this option, FHA or the Government National Mortgage Association (Ginnie Mae)[3] would provide primary bond insurance on HFA's bonds, the proceeds of which would be used to purchase or originate loans. It should be noted that this insurance would be on a pool of loans rather than on individual loans. This option would provide more extensive access to HFA financing for local lenders who are currently originating medium-sized and small loans for affordable multifamily housing.

Option 4: Bond Reinsurance

Under this option, private bond insurers would provide the primary bond insurance to HFAs, with FHA or Ginnie Mae providing reinsurance on their policies. The availability of this reinsurance could encourage private bond insurers to more actively participate in providing credit enhancements for affordable multifamily housing.

FEDERAL CREDIT REFORM ACT OF 1990

If any of the credit enhancement options are adopted, the Federal Credit Reform Act of 1990 requires that the impact on the federal budget be computed. This allows the costs of credit programs to be more easily compared with the costs of other federal spending. Determining the cost of such options to the federal government can be done in several ways.

If expected losses can be estimated directly, the total amount would have to be appropriated by the Congress at the beginning of the program. The amount of reserves would include the present value of expected losses minus any premium paid for the credit enhancements and minus any risk sharing agreements that the federal government would enter into with third parties (e.g. HFAs). If expected losses cannot be directly calculated, the costs can be approximated. It is our understanding that the Office of Management and Budget might make this approximation using comparable bond yields. This would involve determining the difference between the uninsured bond yield and yields on similar bonds with credit enhancements. Because the Federal Credit Reform Act is new and has not been applied to the type of options

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[3] Ginnie Mae, a wholly owned corporation of the federal government, provides a means of channeling capital into mortgage financing.

presented, it is difficult to describe definitively how the costs of the options would be calculated.

NEED TO DEVELOP A DATA BASE ON MULTIFAMILY HOUSING LOANS

As I pointed out earlier in my testimony, for a more active secondary market in affordable multifamily housing to develop, financial institutions need access to information that will enable them to quickly and cheaply evaluate, price, and manage risk. For example, information on foreclosures and losses per foreclosure would permit financial institutions to more accurately price securities. Currently, the data on borrowers' performance in repaying loans for affordable multifamily housing are closely held by individual institutions, and we have been advised that the consistency and quality of the data are quite varied.

The key market participants with whom we spoke all agreed on the benefits of having improved data. Among the major benefits are the ability to evaluate and price risks associated with loans for affordable multifamily housing. This information will assist in the securitizing of affordable multifamily housing loans. In addition, a quality data base could be particularly useful in assisting the bank regulatory agencies in their administration of risk-based capital requirements by providing these agencies with a greater amount of factual data for making their decisions. Currently, such data are not available.

While there is general consensus that a national data base would be desirable, several critical policy and technical issues must be researched and resolved before actually establishing such a data base. Among the more critical issues are

-- ensuring confidentiality and public access,

-- determining whether to use prospective versus past loan performance,

-- defining data and underwriting standards,

-- exploring program management versus project credit risk,

-- estimating costs,

-- determining if supplying data should be voluntary or required,

-- determining who would assemble data, and

-- addressing public subsidy risk.

Each of these issues is discussed in appendix II.

OBSERVATIONS

There is a broad range of mechanisms that the federal government can employ to assist low-income households in meeting their housing needs. My testimony today has focused on one of these avenues--mortgage credit enhancements. Employing credit enhancements to expand the multifamily secondary market would expand the supply and lower the cost of affordable housing. The extent depends on the details of how the policy options might be implemented and the availability of other subsidies needed to make such projects financially viable. We have not attempted to quantify the impact of the options described here or the need for other subsidies.

If such enhancements are employed, it is important that they be cost effective in achieving the desired results. However, ensuring cost effectiveness is partly dependent on having accurate data on the costs and risks involved. Currently, a national data base on performance characteristics of affordable multifamily housing loans does not exist. While we are not in a position to specifically identify who should be responsible for attempting to develop this data base, Fannie Mae, Freddie Mac, and FHA currently hold large portfolios of multifamily mortgages or insure such mortgages. They also are experienced in maintaining large data bases relevant to their particular activities. Moreover, each institution would presumably be a major beneficiary of this data. Other parties which could provide valuable insight in developing a national affordable housing data base are the bank regulatory agencies, the Federal Housing Finance Board, the Bureau of Economic Analysis, and various professional organizations representing mortgage originators.

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Mr. Chairman, we appreciate this opportunity to share our thoughts and ideas with you on this important subject. This concludes my statement, and I would be glad to respond to any questions you might have.

CREDIT ENHANCEMENT OPTIONS

PURPOSE

This appendix discusses in greater detail four options for providing federal credit enhancements for housing finance agencies' (HFAs) loans and loan pools for affordable multifamily housing. While these options have been discussed with officials representing the major state HFAs, as well as FHA, they are still being refined as we complete our review.

As discussed in our statement, each option would require that HFAs agree to assume the expected losses on loans they originate based on their historic loan performance with the federal government covering losses beyond those expected. Again, as we pointed out, there is a tradeoff between the risk to the federal government and the impact on the supply of affordable housing. More risk sharing with the HFAs reduces the federal government's risk but it also reduces the amount of the subsidy for affordable housing.

If the Congress decides to legislate alternative federal credit enhancements, then to the extent possible, it should consider providing specific incentives for HFAs to include experienced local lenders and mortgage banking institutions with successful multifamily affordable housing finance programs as originators and servicers. Some HFAs have "loan to lenders" programs with their single-family mortgage programs and this would be an extension of that program. Local participating lenders would have to agree to use the HFA's underwriting standards and procedures, and loans would likely be limited to financing new construction, where justified, and both substantial and moderate rehabilitation. However, these are the types of loans that are often most needed in housing markets with low vacancies or a shortage of decent housing with larger units to accommodate families with children.

METHODOLOGY

Set forth below are the different options, discussed in terms of the following issues:

-- implementation,

-- eligibility criteria for HFAs,

-- the size and type of loan most likely affected,

-- underwriting criteria (including building codes),

-- access to local financial institutions,

-- advantages, and

-- disadvantages.

OPTION 1: DELEGATED PROCESSING

Implementation

To each eligible HFA, the Federal Housing Administration (FHA) would delegate loan processing authority. FHA would be required to either deny the completed loan application within a specified number of days (e.g., 30 days) of its submission or the individual loan would be automatically approved. If FHA denies a loan, the agency would be required to explain in writing why and what, if any, changes should be made to make the loan acceptable. Such a written explanation would be provided to the HFA within 30 days after the denial. If FHA approves the loan, the agency would provide a 100-percent guarantee. However, the HFA would be required to provide reinsurance, under which it would assume the anticipated first losses of any insured mortgage loans and the first 50 percent of any losses for any construction loans during the construction and lease-up period.

The actual percentage of first losses to be assumed by each HFA would be based on the loan loss performance record of each HFA and the specific risks of each insured loans (determined by considering, for example, the debt service coverage ratio, loan-to-value ratio, operating reserves, etc,).

Eligibility Criteria for HFAs

Any HFA with an acceptable multifamily performance record for comparable loans (size and type) over a specified number of years would qualify.

Size and Type of Loan Most Likely Affected

Mostly larger, more complicated loans that require individual loan guarantees would be affected. Any new construction and substantial rehabilitation loans would also most likely benefit because they require more detailed underwriting analysis than other types of loans (acquisition, moderate rehabilitation, and refinancing).

Underwriting Criteria

For HFAs with exceptional records (superior performance for a specified number of years in handling loans and a highly trained staff), FHA would defer to the underwriting criteria and local building codes of that state. For all other HFAs, modified versions of FHA's underwriting criteria and building codes would apply.

Access to Local Financial Institutions

None. It is assumed that either the HFAs will be too inexperienced to select and monitor local lenders or the loans will be too large and complex for experienced HFAs to delegate to someone else.

Advantages

- This option would be available to a larger number of HFAs than the other options.

- Delegated processing would minimize FHA's staff time and allow staff to concentrate on actual underwriting decisions.

- The specific turnaround time (i.e., 30 days) would provide HFAs an incentive to participate in the program, while encouraging FHA to speed up its decision-making process.

- The additional requirement for FHA to provide within 30 days a written explanation of why a loan has been denied and how the loan could be approved by restructuring (if possible), would also facilitate greater understanding and cooperation between FHA and individual HFAs.

- Since HFAs would remain responsible for the anticipated first losses of mortgage loans and 50 percent of losses on construction loans, the HFAs would have a strong incentive to carefully select projects and conduct their own underwriting prior to applying to FHA.

- Because HFAs with superior records would be allowed to use their own underwriting and state building code standards, other HFAs could be encouraged to develop a similar record that would enable them to use their own standards.

Disadvantages

-- This option would require FHA to develop the capability and procedures to administer this kind of a program, which, though flexible, includes deadlines for decision-making.

-- The option would also require analyzing each HFA's performance record (although using reviews by credit rating agencies would facilitate such an analysis) and developing standards that would distinguish those HFAs with "superior" records.

-- Those HFAs that would be required to follow FHA's underwriting and building code standards may not be interested in participating in the program because of their complexity (although more flexibility is assumed to be required of FHA).

-- The lack of participation by local lenders would limit the number and diversity of loans available to the HFA's.

OPTION 2: DELEGATED UNDERWRITING

Implementation

Eligible HFAs would be delegated underwriting by FHA for loans up to specific limits and for specific types of loans, (i.e., new construction, substantial rehabilitation, refinancing, etc.). These loan limits and types of loans would increase over time as HFAs demonstrate their ability to originate and monitor larger, more complex loans. FHA would provide a 100-percent loan guaranty for individual loans under this option. However, HFAs would be required to assume the top percentage of anticipated losses for the permanent loans (depending upon their debt service coverage ratio, loan-to-value ratio, and operating reserves and the HFAs performance record for comparable loans) and 100 percent of the risk on construction/rehabilitation loans until the project achieved a break-even occupancy rate. If HFAs utilized local lenders in this program, they could be required to assume the 100 percent of the risk during the construction and lease-up period, but only minimal risk during the permanent mortgage because of federal risk-based capital requirements.

Eligibility Criteria

Only those HFAs with successful multifamily performance records for comparable loans (size and type), at least a specified number of years of underwriting experience, and a strong staff with

experience in underwriting and monitoring these types of loans, would be eligible.

Size and Type of Loan Most Likely Affected

The size and type of loan most likely affected would depend on the size and type of loans HFAs (and participating local lenders) had successfully originated and serviced.

Underwriting Criteria

The underwriting criteria and state building codes applicable to participating HFAs would be used.

Access to Local Financial Institutions

Access to local lenders would be limited, depending upon their record for underwriting and servicing comparable loans that the HFAs specialized in originating. Access would vary according to the size and diversity of each state and the potential demand for comparable loans throughout the state.

Advantages

-- Participating HFAs would be authorized to commit FHA to insuring 100 percent of the loan amounts without prior approval by FHA (it is assumed that FHA would conduct annual post-originating audits on a sample of loans to determine HFA's compliance).

-- The percentage of the top risk to be assumed by the HFA would vary with each loan depending upon its risk characteristics and the HFAs' record of originating comparable loans.

-- HFAs would apply their own underwriting criteria, including applicable state building codes, instead of federal standards, which should greatly encourage HFAs to participate in this program.

-- HFAs would be encouraged to specialize in particular types and sizes of loans and to develop a good record in order to participate in this program. Those participating HFAs whose performance begins to deteriorate could be removed from this program by FHA after a hearing is held to determine the effectiveness of the HFAs' record.

-- Experienced local lenders with a successful record of originating and servicing comparable loans would be given

access to permanent mortgage loans that are generally not available today. For projects involving construction or substantial rehabilitation loans and utilizing local lenders, the lenders could be required to provide construction loans directly and assume 100 percent of the risk during the construction and lease-up period, in exchange for a non-recourse permanent mortgage loan assumed by the HFA. Local lenders could also continue to service these loans for the HFAs for a fee.

Disadvantages

-- FHA would have to carefully select participating HFAs. These HFAs would have to develop reliable projections of losses for different types and sizes of loans in order to determine the top percentage of losses that would be assumed for each loan.

-- The quality of each HFAs' staff may change with the departure of one or two senior persons, which could significantly affect the performance of the HFAs' program for multifamily housing loans. FHA's early detection of this and other potential problems associated with specific HFAs is a necessity for the proper implementation of this kind of a risk-sharing program.

-- The number of HFAs that would be eligible to participate in this program would be limited.

-- A rapid deterioration in a particular state's economic conditions could seriously affect the viability of this program and increase FHA's risk exposure beyond anticipated losses.

OPTION 3: PRIMARY BOND INSURANCE

Implementation

FHA or the Government National Mortgage Association (Ginnie Mae) would provide primary bond insurance on HFA bonds, involving a minimum loan volume and number of loans, with no single loan greater than about 10 to 20 percent of the total bond. The insurance would include timely payments of interest and principal to investors. An HFA would be required to assume the top portion of the projected losses in the loan pool. A Standard and Poors (S&P) loan pool loss matrix could be used to calculate expected losses. Although the actual losses for each HFA could be substituted for S&P's data if it is determined that there is sufficient loan volume and seasoning to rely on the HFA's past

performance for comparable loans. The HFA would be responsible for 100 percent of the risk during the lease-up period for new construction and substantial rehabilitation loans. Only HFA bonds that were rated internally as BBB or lower (without any additional insurance, but including normal reserves) and that included at least 50 percent of the units serving households with 60 percent or less of the area's median family income would be eligible for a primary federal government bond credit enhancement.

In the event that HFAs otherwise eligible to participate in this program lacked the loan volume (including participation by local lenders) to create bonds large enough to justify normal bond expenses, consideration could be given to giving either FHA or Ginnie Mae the authority to provide a credit enhancement to pool the loans from several participating HFAs. Such a "multistate" HFA security would have to be issued by a qualified financial intermediary such as an investment banking firm and would be required to be certified by FHA or Ginnie Mae.

Eligibility Criteria

Only those HFAs that have had superior performance records for comparable loans for a specified number of years and that maintain a high-quality multifamily staff and loan performance record would be eligible. FHA or Ginnie Mae would be required to monitor each HFA's performance at least annually and certify that the HFA continues to meet performance and staffing requirements.

Size and Type of Loan Most Likely Affected

Mostly small to medium-sized loans ($250,000 to $2 million) involving a broad range of financing, including projects receiving tax credits, would be affected.

Underwriting Criteria

Underwriting criteria would be the same as option 2.

Access to Local Financial Institutions

Available to local lenders with relatively large loan volumes that the HFA otherwise could not directly serve. Participating lenders would be required to meet specific minimal standards prior to becoming eligible (such standards and decisions would be the exclusive responsibility of each participating HFA).

Advantages

-- This option should generate a high volume of loans for affordable housing that either are not being originated today or are being offered with short terms and variable rates that increase credit risks.

-- This option should provide faster and more extensive access to HFAs' financing through local participating lenders for medium-sized and small loans with minimal risk to the HFAs and local lenders (the former take the long-term credit risk and the latter the short-term market and construction risk).

-- The federal government would not be involved in the underwriting process of loans. Only minimal audits after loans have been originated would be needed as long as HFAs' loan performance remains high. The major responsibility for the federal government would be to select "superior" HFAs with excellent performance records for comparable loans and to determine whether to allow the HFAs to substitute their loan performance data for S&P's.

-- HFA bonds with credit enhancements from FHA or Ginnie Mae would receive AAA+ credit ratings and provide liquidity to investors, particularly state pension funds that have been reluctant to purchase HFA bonds without this type of credit enhancement.

-- The availability of insured pass-through securities involving several loans would significantly increase the access of these HFAs to public capital markets that are otherwise closed to them.

-- This option would yield the same advantages in underwriting as option 2.

-- Lenders would not compete with private bond insurers since they rarely are interested in bonds with BBB ratings or less.

Disadvantages

-- These new responsibilities would require the entity providing the credit enhancement to have the trained staff to do the required reviews. FHA and Ginnie Mae would have to work cooperatively to establish new risk-based performance data systems that would have to determine the eligibility of different HFAs and HFAs' loan pools. Once

these systems were established, they would have to be monitored regularly to detect any potential problems at an early stage before they became serious.

-- HFAs with small staffs could have serious problems monitoring the loans by local lenders with substantial loan volume.

-- This option would present similar regional market problems as discussed under option 2.

-- Investment banking firms' ability to purchase small loan pools from individual HFAs and pool them with other HFA loan pools could cause logistical and interest rate risk problems.

OPTION 4: BOND REINSURANCE

Implementation

Private bond insurers would provide the primary bond insurance to HFAs, with FHA or Ginnie Mae providing reinsurance on their policies. This option would work for HFA bonds rated A or better or did not include the 50-percent minimum affordability test discussed in option 3. This reinsurance would not cover more than 50 percent of the primary insurers' losses, assuming that private bond insurers would provide the primary credit enhancement.

Eligibility Criteria

Eligibility criteria would be the same as for option 3, except that smaller HFAs with lower loan volumes would probably not be able to participate unless a regional or national investment banking institution was willing to issue a regional or national bond involving several HFAs.

Size and Type of Loan Most Likely Affected

This option would probably result in fewer new construction and substantial rehabilitation projects and somewhat larger loans because private bond insurers tend to be averse to risk.

Underwriting Criteria

Underwriting criteria would be same as for option 2.

Access to Local Financial Institutions

Access would be more limited than for option 3 and possibly even option 2 because bond insurers may be reluctant to allow delegated underwriting to local lenders with whom they are not familiar.

Advantages

-- Larger HFAs with larger loan volumes and prior credit rating experience should have much easier access to private bond insurers because of the government reinsurance. Such a credit enhancement should also increase the market acceptance of these bonds because of the federal government's involvement. This should interest private bond insurers that may want to increase their housing bond business with less additional risk (and therefore capital reserves).

-- Similar advantages as Option 3 except for possibly limiting local lenders' participation.

-- The federal government would have less risk exposure and responsibility for monitoring loan pools because of the private sector's increased involvement. Less risk will also mean lower congressional appropriations needed to offset possible losses, as required by the Credit Reform Act.

Disadvantages

-- HFAs would depend on private bond insurers' willingness to provide primary credit enhancement to these kind of bonds conditioned upon a reinsurance commitment by the federal government. The relationship between each of these bond insurers and either FHA or Ginnie Mae would have to be worked out in detail before such a program could operate nationally.

-- The reserves and collateral required by bond insurers may be too difficult for some HFAs to provide, even with government reinsurance.

-- In the event that a private bond insurer experienced serious financial difficulty (and therefore a lower credit rating), the federal government may be required to assume some of the bond insurer's liability to maintain the bond's economic viability. (Lower credit ratings usually cause a technical bond "default," which would require that the bond

be refinanced). Since bond insurers are only regulated by state governments, FHA or Ginnie Mae may have little control over such situations unless their control is agreed to by all participating parties as a condition to the federal government's commitment to provide reinsurance.

-- The premiums charged by the bond insurers may be too high for some housing projects to afford.

MULTIFAMILY MORTGAGE DATA BASE

ENSURING CONFIDENTIALITY AND PUBLIC ACCESS

Lenders are particularly concerned that their data remain confidential. In this regard, they point out that any federal agency administering this program would be subject to the Freedom of Information Act and may be required to reveal confidential information from its sources. On the other hand, everyone agreed that summaries of data should be available. Such public access is critical to gaining a better understanding of many of the economic and social questions concerning both conventional and affordable loans for multifamily housing.

DETERMINING WHETHER TO USE PROSPECTIVE VERSUS PAST LOAN PERFORMANCE

Requiring lenders and secondary market institutions to complete questionnaires for new loans is much less costly and time-consuming than requesting them to reconstruct data for their existing loans. However, limiting the national data base to only new loans will mean that its utility may be 3 to 5 years into the future. Possible "hybrid" solutions have been proposed such as requiring past loan performance for only a small percentage of each institution's origination or purchases on either a random or representative sample basis. However, because previous loans were originated without uniform definitions, the utility of past data is highly questionable.

DEFINING DATA AND UNDERWRITING STANDARDS

There are no uniform definitions for many of the data items that may be included in the data base. For example, debt service coverage with multiple mortgages. Underwriting standards also vary among lenders, particularly those financing projects to provide affordable housing. There would need to be broad consensus about the kinds of data to include in the data base and a common definition for each data item.

EXPLORING PROGRAM MANAGEMENT VERSUS PROJECT CREDIT RISK

There is a distinction between these two types of risks, but we know very little about them. Exploring this issue may also run counter to ensuring confidentiality since keeping information provided by the program manager from the project's management could be difficult. Even if the two were not specifically mentioned by name, it would probably be evident to most analysts who they were.

ESTIMATING COSTS

What would be the estimated costs to both the data providers and to the data assembler? Also, how much of these costs could realistically be offset by fees charged to potential users?

DETERMINING IF SUPPLYING DATA SHOULD BE VOLUNTARY OR REQUIRED

Should the data be provided voluntarily or should it be required by a federal law? What are the constitutional and legal issues that may arise from the latter approach and the probable compliance from the former approach?

DETERMINING WHO WOULD ASSEMBLE DATA

Which agency or organization should be given the authority and responsibility of assembling, disseminating, and analyzing this data? If a federal law is deemed necessary, which federal agency would be best suited to operate such a complex and specialized program? If a voluntary system is appropriate, are there any existing organizations capable of operating it, or would a new organization be more desirable.

ADDRESSING PUBLIC SUBSIDY RISK

Most lenders would like to standardize the public subsidies that are needed by many projects providing affordable housing. Effectively performing such a complex objective, particularly for the wide variety of local and state government subsidies that are being used today, will require a fundamental understanding of their effectiveness and shortcomings. The national data base is perhaps the only vehicle for such an undertaking because it would be able to gather data across institutional and programmatic "lines."

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